The Macro Environment For Financial Markets

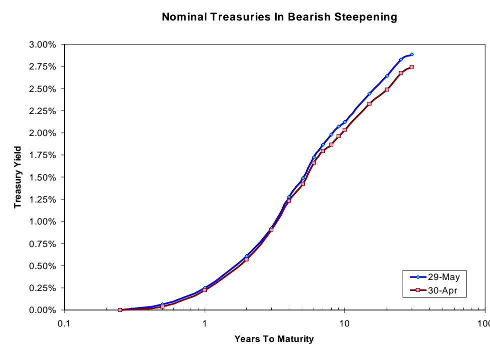
Economies are subject to aviation analogies only in the minds of central bankers. Thus we used to hear of "soft landings" just as we hear now of "takeoff points." Years of dwindling SAT verbal scores should have told us this day of reckoning with inappropriate analogies would arrive. What we have not heard is a coherent explanation of how higher short-term interest rates will solve the mismatches in the U.S. labor force between demand for skills and excess supply amongst the creatively destructed, nor have we heard how those same higher short-term interest rates would reduce any nascent inflationary pressures. They did not work in the 1970s nor did years of global QE and ZIRP have the opposite effect after the financial crisis. However, these demonstrable absences of success have not stopped the assumption of deterministic outcomes for monetary policy. There might be solid reasons for raising short-term interest rates, but the fact QE and ZIRP failed are not on that list. Moreover, we should stop idle chatter's effect on currencies for the same reason we discourage children from playing with matches.

The causal chain is now:

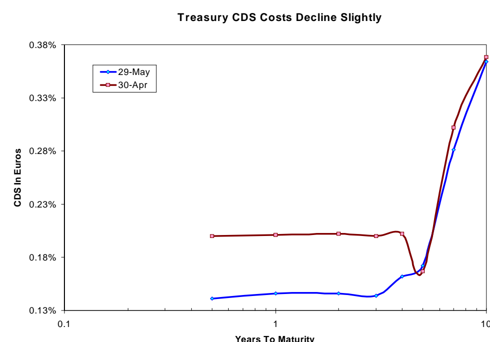
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point;
2. Disinflationary pressures are starting to abate, but this will not be a uniform process either across economies or between economic sectors;
3. Inflation expectations as measured by the TIPS market have resumed their primary downtrend;
4. The U.S. yield curve has resumed its long-term bias toward flattening;
5. Short-term borrowers are terming out commercial paper into the bond market in an attempt to lower rollover risk;
6. Swap spreads will remain tame until monetary policy indications turn more hawkish; and
7. Credit spreads will remain well-confined at historically low levels.

Key Market Indications

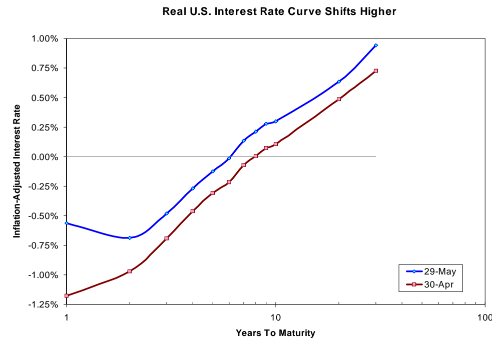
While long-term rates remain over month-ago levels, the primary trend toward a bullish flattening of the yield curve remains intact. This will be reinforced by the renewed decline in key European long-term rates and by declining inflation expectations.



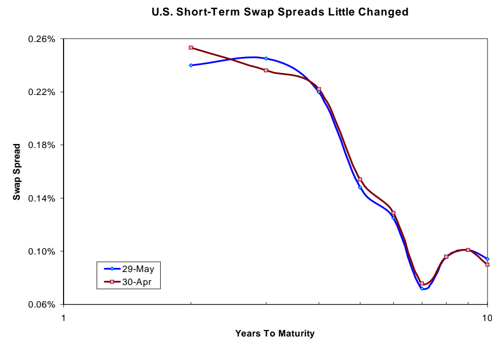
This market has little reason to shift significantly in either direction. Even if the U.S. federal budget picture was to deteriorate suddenly, do you believe the euros these swaps are priced in will be around as a viable alternative? Quite simply, Washington has lost its mojo when it comes to manufacturing budget crises; memorabilia collectors building an Obama-era portfolio may want to get their hands on some Standard & Poor's downgrade notices. They could be worth something someday.



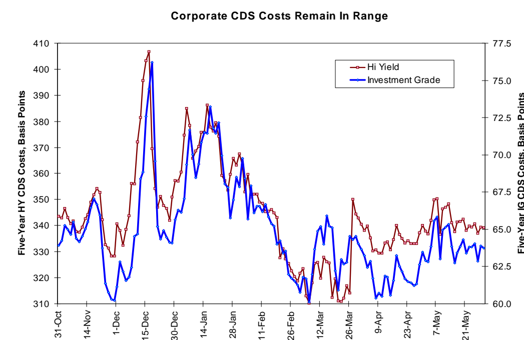
Pseudo-real rates have shifted higher and are negative out to "only" six years at this point. The rise seen over the past month is attributable to the artifact of timing and the then-extant bearish steepening of the yield curve. Implied real rates have not increased sufficiently at the long end to pose a threat to risky financial assets, but they have increased enough at the short end to dampen demand for precious metals.



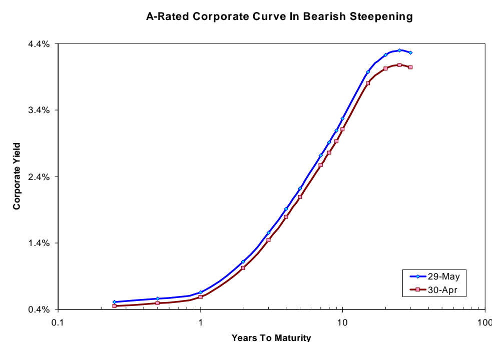
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates. The market remains complacent, perhaps dangerously so, over stable long-term rates.



Both investment-grade and high-yield CDS costs remain in their trading ranges. Interestingly the prospect of higher short-term rates has not affected either index; this is a tribute to the prevalence of strong balance sheets after six and one-half years of ZIRP.



The A-rated yield curve has steepened bearishly over the past month, but this shift has been quite small. Unless CDS costs and swap spreads increase, this should not present any sort of headwind for equities.



Market Structure

The main Bloomberg index has resumed its primary downtrend along with every subindex save Petroleum and Livestock. Within the financials, the S&P 500 and EM indices have moved into structural downtrends with the dollar index sitting on the cusp of a structural uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate June 1 - 5
BBerg	29	Trending	-0.205	10.4%	-0.35%
BBerg Grain	17	Transitional	-0.190	15.7%	
BBerg Ind. Metl	29	Trending	-0.306	14.7%	-0.61%
BBerg Pre. Metl	29	Trending	-0.027	13.9%	-0.37%
BBerg Softs	29	Trending	-0.327	17.2%	-1.10%
BBerg Nat. Gas	29	Trending	-0.181	29.4%	-1.49%
BBerg Petroleum	16	Transitional	0.009	23.4%	
BBerg Livestock	29	Trending	0.071	9.9%	0.11%
Dollar Index	29	Trending	0.131	9.7%	
S&P 500 Index	26	Trending	-0.021	8.0%	-0.13%
EAFE Index	17	Transitional	-0.142	10.0%	
EM Index	20	Trending	-0.343	8.5%	-0.14%
Ten-year UST (price)	11	Transitional	0.093	5.6%	

Performance Measures

Individual commodity/currency correlations of returns are not very strong and certainly are not very stable over time, but that does not preclude short-term episodes such as seen over the past two weeks between USD strength and physical commodity weakness. Barring cattle and cotton on the commodity side and the CNY and CHF on the currency side, it would have been a second consecutive near- clean sweep in the dollar-up/commodities-down matrix. I must emphasize these currency/commodity relationships are not causal but rather anecdotal; in any event, the realized changes in commodity prices would imply completely fantastical gearing ratios to individual currency changes.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.70%	-2.37%	-12.05%	-24.55%
Grains Sub-Index	-4.06%	-2.33%	-14.84%	-29.79%
Corn	-3.70%	-3.17%	-13.44%	-31.57%
Soybeans	-0.48%	-3.19%	-9.57%	-27.67%
Wheat	-8.62%	0.63%	-21.09%	-28.28%
Energy Sub-Index	-3.57%	-2.15%	-21.42%	-41.80%
Petroleum Sub-Index	-0.99%	-0.80%	-15.51%	-41.02%
WTI	-0.69%	-0.10%	-20.98%	-44.55%
Brent	-1.25%	-2.42%	-17.36%	-45.39%
ULSD	-2.02%	-1.93%	-9.32%	-31.37%
Gasoline	-0.25%	1.66%	-7.50%	-35.34%
Natural Gas	-11.75%	-6.67%	-37.93%	-48.51%
Precious Metals Sub-Index	-1.61%	1.82%	-1.98%	-6.56%
Gold	-1.27%	1.22%	-2.55%	-4.90%
Silver	-2.52%	3.51%	-0.46%	-11.82%
Industrial Metals Sub-Index	-2.92%	-7.94%	-10.91%	-13.09%
Copper	-4.23%	-6.88%	-5.92%	-12.87%
Aluminum	-2.16%	-9.98%	-16.53%	-9.90%
Nickel	-2.97%	-8.35%	-23.26%	-35.66%
Zinc	-0.16%	-7.07%	-3.13%	4.21%
Softs Sub-Index	-2.30%	-7.83%	-21.00%	-34.31%
Coffee	-1.79%	-6.00%	-36.09%	-35.52%
Sugar	-4.08%	-7.20%	-22.35%	-42.57%
Cotton	0.97%	-3.39%	8.08%	-16.51%
Livestock Sub-Index	-0.04%	2.64%	-11.42%	-6.62%
Cattle	0.25%	2.41%	-4.65%	12.70%
Hogs	-0.48%	3.00%	-23.10%	-32.90%

When confronted with an armed raving lunatic, should you say, "This doesn't make any sense," or should you get out of the way ASAP? While the shifting consensus toward higher short-term rates in the U.S. may not make any immediate sense, those who choose to remain short the USD will get crushed. The one exception of note is the CHF, which has seen renewed haven bids related to the ongoing Greek saga.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.25%	-1.28%	-11.90%	-19.23%
Chinese yuan	0.00%	0.03%	-0.76%	0.68%
Japanese yen	-2.10%	-4.13%	-4.63%	-18.01%
British pound	-1.28%	-0.95%	-2.79%	-8.53%
Swiss franc	0.34%	-0.11%	2.59%	-4.51%
Canadian dollar	-1.41%	-3.48%	-9.03%	-12.98%
Australian dollar	-2.28%	-4.53%	-9.96%	-17.86%
Swedish krona	-1.47%	-2.21%	-12.68%	-21.99%
Norwegian krone	-1.60%	-3.17%	-10.72%	-23.22%
New Zealand dollar	-2.76%	-7.46%	-9.66%	-16.24%
Indian rupee	-0.48%	-0.81%	-2.82%	-7.50%
Brazilian real	-2.66%	-6.84%	-19.44%	-30.03%
Mexican peso	-0.73%	-0.97%	-9.01%	-16.50%
Chilean peso	-1.53%	-1.55%	-0.68%	-11.15%
Colombian peso	-1.62%	-6.04%	-10.55%	-24.72%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.56%	-1.14%	-1.50%	-3.39%

In a normal world, equity markets faced with decreasing earnings growth and rising currency volatility should decline. The fact May was only a modestly poor month confirms this is not a normal world. Those who wish for normality in the form of higher short-term interest rates had better be ready to accept the consequences of wish-fulfillment.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.30%	-0.52%	3.71%	6.39%
North America	-0.96%	-0.12%	2.77%	10.86%
Latin America	-4.41%	-8.06%	-15.62%	-22.63%
Emerging Market Free	-3.18%	-5.04%	0.96%	-0.72%
EAFE	-1.82%	-1.14%	5.19%	0.00%
Pacific	-0.65%	-2.50%	9.63%	8.77%
Eurozone	-3.15%	-1.02%	0.51%	-6.77%

Both CTAs and hedge funds managed gains over the week, suggesting a decreased reliance on long equity positions increased and exposure to a stronger USD.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.82%	-3.87%	5.33%	25.77%
Newedge Trend	0.21%	-2.52%	4.06%	17.78%
Newedge Short-Term	-0.01%	-1.01%	0.93%	8.39%
HFR Global Hedge Fund	0.00%	-0.08%	1.86%	1.30%
HFR Macro/CTA	1.21%	-0.46%	1.95%	7.84%
HFR Macro: Sytematic Diversified CTA	1.42%	-1.71%	2.17%	7.13%